REV-05 INCREASE EXCISE TAXES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Extend the Telephone Tax	1.3	2.3	2.5	2.7	3.0	11.7
Raise the Cigarette Tax to 32 Cents per Pack	2.9	3.1	3.1	3.0	2.9	15.1
Increase Taxes on Distilled Spirits	0.4	0.6	0.6	0.6	0.6	2.7
Raise Taxes on Beer and Wine to Rate on Distilled Spirits	4.2	5.7	5.8	5.9	6.0	27.6
Index Current Cigarette and Alcohol Tax Rates for Inflation	0.4	0.7	1.1	1.2	1.4	4.8

Additional revenues could be raised by extending the temporary increase in the telephone tax that was imposed in recent tax legislation, and by increasing alcohol and tobacco taxes.

Extend the Telephone Tax. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) raised the excise tax on local and long-distance telephone service and teletypewriter exchange service to 3 percent for calendar years 1983 through 1985. The Deficit Reduction Act of 1984 (DEFRA) extended the 3 percent rate through calendar year 1987. Extending the tax beyond 1987 at the 3 percent rate would raise revenues (net of reduced income taxes) by about $12 billion over fiscal years 1988-1992. Extending the tax and raising the rate to 4 percent would raise net revenues by about $15 billion over the five-year period.

The primary justification for the tax is that it can raise large revenues with a low tax rate. Other arguments for the tax are that it is a broadbased tax, since virtually all households have telephones, and that the cost to the government of administering the tax is low. One argument against the tax is that it burdens households in proportion to their use of telephone services rather than their ability to pay taxes or some other standard of fairness. The tax is also a larger portion of both household incomes and expenditures for low-income households than for households with higher incomes.1/ Finally, the tax is also criticized because it applies even to basic local telephone service, which many regard as a necessity.

Increase the Cigarette Tax. TEFRA increased the cigarette tax from 8 cents per pack to 16 cents for the period from January 1, 1983, to September 30, 1985. The 16-cent rate was subsequently extended through March 15, 1986, and then made permanent. The tax is now about 15 percent of the current average market price (including tax) per pack, significantly less than the 42 percent of the price that the 8-cent tax represented when it was set in 1951. Increasing the tax to 32 cents per pack on October 1, 1987, would raise net revenues about $15 billion between 1988 and 1992. Increasing the tax to only 24 cents per pack would increase net revenues by about $8 billion over five years.

An increase in the cigarette tax could be seen as compensation for the costs of smoking that society ultimately bears, such as the increased medical costs of both smokers and nonsmokers attributable to smoking. It might also discourage smoking by raising prices, which would probably affect the young most and could result in long-run improvements in health. On the other hand, if the increase exceeded the net costs imposed on other taxpayers by smokers, it could be regarded as discriminatory against smokers (about 30 percent of the adult population). In addition, the tax is a higher share of the income and expenditures of low-income households than of households with higher incomes.2/ Finally, increases in the federal cigarette tax might have an adverse effect on state and local revenues from cigarette taxes and could substitute for state increases in these taxes.

Increase Taxes on Alcoholic Beverages. The tax on distilled spirits was increased by DEFRA to $12.50 per proof gallon effective October 1, 1985. This was the first increase in the distilled spirits tax since 1951, when the rate was set at $10.50 per proof gallon. In 1951, the tax was about 43 percent of the average product price; by comparison, the current tax is about 27 percent. Increasing the tax to $15.00 per proof gallon on October 1, 1987, would raise about $3 billion in net revenues over the 1988-1992 period. At this rate, the tax would be about 32 percent of the average prod-

1. See Congressional Budget Office, "The Distributional Effects of an Increase in Selected Federal Excise Taxes" (Staff Working Paper, January 1987).

2. Ibid.

uct price, still well below that in effect in 1951, and the price of a typical bottle of bourbon would be about 5 percent higher than under the current tax rate.

The per unit taxes on beer and wine have not changed since 1951. Moreover, beer and (especially) wine are currently taxed significantly more lightly than distilled spirits. Increasing the tax rates on beer and wine to the alcohol-equivalent rate of the current tax rate on distilled spirits, effective October 1, 1987, would raise about $28 billion (net) between 1988 and 1992. This would increase the tax on a fifth of wine from 3 cents to 55 cents, and the tax on a six-pack of beer from 16 cents to 65 cents. Similarly, increasing the tax on wine to the alcohol-equivalent rate of the current tax on beer would raise about $5 billion (net) through 1992.

Increased taxes on alcoholic beverages would bring the tax rates more into line with historical rates, and would help to offset the social costs of drinking (such as from alcohol-related automobile accidents). On the other hand, some people argue that increases would make tax rates on alcoholic beverages unjustifiably high compared with the social costs of drinking. Opponents of tax increases argue that alcohol taxes are regressive when measured as a share of household incomes. The CBO study cited above indicates that these taxes account for a higher share of household income for low-income households than for those with higher incomes, but are about the same share of household expenditures for those at all income levels. Opponents also argue that increases in the federal tax rates might interfere with a tax base tapped by the states.

Index Cigarette and Alcohol Tax Rates for Inflation. Indexing the taxes on cigarettes and alcoholic beverages to the Consumer Price Index would ensure that tax revenues keep pace with inflation. Indexing current cigarette and alcohol tax rates to changes in the CPI after October 1, 1987, would raise about $5 billion in net revenues over the 1988-1992 period.

Indexing of these taxes would prevent inflation-induced erosion of tax revenues in a gradual and predictable manner, thereby avoiding abrupt increases in unit rates. On the other hand, some people think excise taxes are an inferior way of raising revenues compared to income or general sales taxes, and would prefer to allow their relative burden to decline over time.

An alternative to indexing would be to convert the unit taxes to *ad valorem* taxes (set as a percentage of manufacturers' prices). This method would accomplish the same objective of tying tax revenues to price increases, although revenue would be tied to the prices of the taxed goods, not the general price level. Administration of *ad valorem* taxes would be more complex because of the need to impute manufacturers' prices when the goods are sold by manufacturer-controlled wholesalers and retailers.

REV-06 REPEAL EXEMPTIONS TO THE GASOLINE EXCISE TAX

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Repeal Gasohol Exemption and Credit	0.2	0.3	0.3	0.3	0.3	1.2
Repeal Bus Exemption	0.1	0.1	0.1	0.1	0.1	0.5

Excise taxes on motor fuels, tires, truck sales, and truck use are used to finance spending on federal aid for highways. These taxes can be considered user fees, and are earmarked for the federal Highway Trust Fund to be used for investment and maintenance of the highway system. Certain users, including public and private bus services, are partially exempt from these taxes. In addition, gasohol and methanol are exempt from tax (or producers may claim an income tax credit) in an attempt to promote conservation of nonrenewable resources. The President's budget for 1988 includes a proposal to repeal these exemptions plus the exemption from all federal highway excise taxes for state and local governments. Proposals to repeal the gasohol exemption and credit and the exemption for buses are described separately below. In order for the resulting revenues to reduce the deficit, they must be retained in the Trust Fund or allocated to the general fund instead of being used to support additional spending for highways.

Repeal the Gasohol Credit and Exemption. Under current law, gasohol (a mixture of gasoline and at least 10 percent ethanol) is exempt from six of the nine cents excise tax on gasoline. Alternatively, ethanol producers are eligible for a credit taken against their income taxes of $0.60 per gallon. The exemptions and credit apply only to ethanol manufactured from biomass (organic materials) and used as fuel. The ethanol credit and exemptions are scheduled to expire at the end of 1992. Repeal of the credit and exemption for gasohol fuel effective October 1, 1987, would raise $1.2 billion between 1988 and 1992.

Another alcohol fuel produced from biomass--methanol--is completely exempt from tax, but this exemption does not currently decrease revenues because engines now available cannot use methanol as fuel. If the gasohol credit and exemption are repealed, repeal of the methanol exemption should also be considered for consistency and to prevent a future revenue loss if technological change increases the importance of methanol as a motor fuel.

The credit and exemptions are intended to encourage production of fuels made from renewable resources so that U.S. dependence on fossil fuels will decline. This tax subsidy is particularly helpful to farmers who grow corn, because corn is the primary ingredient used in ethanol production. Given the current low prices of oil, however, production costs of ethanol exceed the price of gasoline even when all tax subsidies and other federal subsidies are taken into account. Other subsidies to encourage ethanol production include the energy investment tax credit, federal funds for ethanol research, and federal loan guarantees for construction of alcohol production facilities.

Repeal of the subsidy is favored by those who believe that it leads to an inefficient use of resources, because it encourages production of high-cost alcohol fuels to substitute for lower-cost gasoline. An argument against repeal of the exemption and credit is that ethanol producers have invested in plant and equipment for ethanol production believing that the exemption and credit will continue at least until 1992. Some of these plants could, however, be converted to other uses, such as production of corn sweeteners. Another argument is that the subsidies help raise farm incomes. A study by the Department of Agriculture has indicated, however, that it would cost less to pay farmers a direct subsidy equal to the amount they would receive as a result of ethanol production than to continue with the tax subsidy.

Repeal the Tax Exemption for Buses. Under current law, public and private buses are generally exempt from paying excise taxes on gasoline, diesel fuel, and tires. Repeal of this exemption effective October 1, 1987, would raise $0.5 billion over the 1988-1992 period.

The purpose of the exemption is to encourage the use of public transportation, which may reduce congestion on roadways and conserve energy. Proponents of this proposal argue that buses should pay these taxes as fees for highway use.

REV-07 REDUCE TAX CREDITS FOR REHABILITATION OF OLDER BUILDINGS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Limit Rehabilitation Tax Credits to Historic Renovations	a/	0.1	0.2	0.3	0.3	0.9
Repeal the Credits	0.3	0.7	1.4	1.8	1.9	6.0

a. Less than $50 million.

Tax credits for rehabilitation are intended to promote the preservation of historic buildings; encourage businesses to renovate their existing premises rather than relocate; and encourage investors to refurbish older buildings by partially, if not completely, compensating them for forgoing the higher returns they might achieve from new construction. The Tax Reform Act of 1986 replaced a three-tier rehabilitation tax credit ranging from 15 percent to 25 percent with a two-tier credit of 10 percent for expenditures on structures built before 1936 and 20 percent for buildings certified as historic structures by the Department of the Interior.

The credits favor commercial use over most rental housing and may, therefore, divert capital from more productive uses. Commercial buildings can qualify for the credit even if not in a historic district, but credits for rental housing are available only for historic buildings. In favoring renovation over new construction, the credits may encourage more costly ways of obtaining more housing and commercial buildings.

Rehabilitation may, however, have social benefits: it may lessen the outflow of jobs from urban areas or discourage destruction of historically noteworthy buildings. This latter objective may be accomplished at lower cost by retaining a credit only for renovation of certified historic buildings. Some surveys have indicated that a 15 percent credit would be sufficient to cover both the extra costs of obtaining certification and of historic-quality rehabilitation. If the credit were retained only for historic structures at a 15 percent rate, revenue gains over the 1988-1992 period would be $0.9 billion. Repeal of the credit would raise $6.0 billion over the same period.

REV-08 TAX CREDIT UNIONS LIKE OTHER THRIFT INSTITUTIONS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1988	1989	1990	1991	1992	
Addition to CBO Baseline	0.2	0.4	0.4	0.5	0.5	2.0

Credit unions, organized for the benefit of members and operated without profit, are not subject to federal income taxes and hence are treated more favorably than competing thrift institutions. Taxing credit unions like other thrift institutions would raise about $0.2 billion in 1988 and about $2 billion through 1992.

Historically, savings and loan institutions, mutual savings banks, and credit unions were tax-exempt because they were regarded as operating for the sole benefit of their members. In 1951, though, the tax exemptions for the first two groups were removed because they were recognized to resemble corporations more closely than mutual organizations. Today, credit unions have more than 43 million members and over $99 billion in assets and are comparable in strength and services to taxable thrift institutions. Permitting the passthrough of income to credit union members with no tax at the "corporate level" gives credit unions a cost advantage. This is contrary to the intent of deregulation of the financial services sector, which was to lessen distinctions among providers of financial services.

The tax acts of 1982, 1984, and 1986 greatly limited the tax preferences of taxable thrift institutions. The resulting increase in the tax burden of taxable thrift institutions increases the competitive advantage that credit unions derive from escaping taxation. Credit unions claim, however, that the original reason for their special tax treatment--that they operate solely for the benefit of their members--justifies their current status.

REV-09 REPEAL TAX PREFERENCES FOR EXTRACTIVE INDUSTRIES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Repeal Percentage Depletion	0.5	0.9	0.9	1.0	1.0	4.2
Repeal Expensing of Intangible Drilling, Exploration, and Development Costs	1.1	1.7	1.4	1.2	1.1	6.5
Bring Oil and Gas Losses Within the Passive Loss Limitation	0.1	0.3	0.3	0.4	0.5	1.6

Businesses engaged in extracting hard minerals or energy enjoy tax preferences available only to them in the form of special cost recovery rules. In addition, certain oil and gas investors are exempted from the passive loss limitation enacted in the Tax Reform Act of 1986.

Repeal Special Cost Recovery Rules. Mineral properties, such as oil and gas wells, coal mines, or gravel quarries, are similar to depreciable assets in that they require large "up front" expenditures to produce assets that generate future income. These capital costs for mineral properties are of three types: costs associated with acquiring mineral rights and exploring for possible mineral deposits; development costs, including expenses such as those related to drilling oil wells or mine excavation; and costs for capital equipment, such as pumps or construction machinery. Under general income tax accounting principles, such capital costs may not be deducted immediately (that is, may not be expensed) but must be "capitalized" and recovered in future years through depreciation or depletion deductions. Extractive industries, however, are allowed to expense certain capital costs that normally would have to be depreciated and to take depletion deductions for other capital spending that exceed the actual amount of such spending.

The items that may be expensed are certain exploration and development costs for hard mineral industries (such as coal or iron ore) and much of the costs necessary to prepare and drill wells for oil and gas (called intangible drilling costs). In the case of corporations engaged in hard mineral extraction and integrated producers of oil and gas, expensing is limited to 70 percent of these costs, with the remaining 30 percent deducted over a 60-month period. In addition, hard mineral exploration costs are subject to recapture once a mine is brought into production. (Recapture involves including exploration costs as income in the year the mine begins production.)

Under cost depletion, firms are allowed to deduct costs according to the percentage of estimated reserves produced each year. For example, if 5 percent of a well's remaining reserves is produced in a given year, 5 percent of the well's unrecovered depletable costs is written off in that year. The total amount of cost depletion deductions allowed over time equals the total amount of capitalized costs. Many taxpayers, however, are allowed the alternative of percentage depletion to compute their annual depletion deduction. Percentage depletion allows firms to deduct a certain percentage of the gross income from a property as depletion, regardless of the firm's actual capitalized costs. For example, nonintegrated oil and gas companies are allowed to deduct 15 percent of the gross revenue from their first 1,000 barrels per day of oil and gas production each year, regardless of their capitalized costs. (Integrated oil and gas producers are required to use cost depletion for recovering capitalized costs.) Hard mineral producers are also allowed to use percentage depletion at varying statutory rates. Minerals eligible for percentage depletion include coal (10 percent), uranium (22 percent), oil shale (15 percent), gold (15 percent), and iron ore (14 percent).

The current tax treatment of mineral and energy properties has been criticized because many of the preproduction expenses of mineral properties can be deducted faster than the value of the assets they "produce" declines. For example, drilling expenditures by oil companies produce assets (that is, producing wells) that gradually decline in value as oil reserves are depleted. The tax code, however, allows firms to deduct most of these costs in the year incurred. Moreover, percentage depletion often allows firms deductions in excess of their original investment. In some cases, percentage depletion (in present-value terms) is even more generous than expensing of all depletable costs.

Because of these provisions, mineral and energy producers face effective tax rates that are lower than statutory tax rates and, for many producers, lower than effective tax rates on other industries. The Tax Reform Act increased the effective rates on most industries by, among other things, replacing the Accelerated Cost Recovery System (ACRS) of depreciation with one that is less generous for many assets and eliminating the investment tax credit. At the same time, the act made only minor changes to tax preferences for extractive industries. These tax advantages could be eliminated by requiring all expenditures on mineral and energy rights, and on exploration, development, and drilling of productive mines and wells, to be capitalized and recovered by cost depletion. (Expenditures on dry holes, unproductive mines, or worthless mineral rights would, however, still be expensed.) Repeal of percentage depletion would raise about $0.5 billion in 1988 and $4.2 billion over the 1988 to 1992 period. Repeal of the expensing provisions would raise about $1.1 billion in 1988 and $6.5 billion over the 1988 to 1992 period.

Opponents of expensing and percentage depletion argue that the inherent subsidy they provide is not needed, and that, as a result of these subsidies, too much capital is allocated to extractive industries as opposed to other more productive uses. Further, the subsidies may cause greater consumption of domestic resources (especially oil and gas) and less of imported resources. Providing the subsidies has been called a policy of "draining America first," which may result in greater reliance on foreign energy producers in the future. (This argument has also been made regarding an oil import fee; see REV-04.) Finally, it is argued that the differential taxation of integrated and independent oil companies is an inefficient way of promoting oil production.

The major argument for retaining the expensing and percentage depletion provisions is that they provide necessary incentives for increasing domestic production of oil, other fuels, and hard minerals. Furthermore, proponents argue that because the oil and gas industry is highly risky, especially for small firms, favorable tax treatment is required so that firms can raise sufficient capital. Moreover, extractive industries are facing particularly hard times at the moment and some people argue that it is a bad time to increase their tax burden. If preferences for extractive industries are not eliminated directly, their use as tax shelters could be curtailed by extending the passive loss limitations to extractive industries, as described next.

Exception to Passive Loss Limitation. As a result of the Tax Reform Act, losses from passive business activities (those in which the taxpayer is not involved in a regular, continuous, and substantial basis) may not be used to offset the taxpayer's other income, such as salary, interest, dividends, and active business income. This limitation was imposed to reduce tax shelter activity. An exception was made for working interests in oil and gas properties where the taxpayer's liability is not limited by the form of ownership. Repealing this exception for the oil and gas industries would raise $1.6 billion between 1988 and 1982.

This exception was made at a time when world oil prices had declined sharply, reducing profitability for the oil and gas industry. Despite some recent upturn in world oil prices, conditions in the domestic oil industry are still very depressed. Some people argue that the riskiness of oil and gas ventures makes it difficult for them to attract sufficient investment capital, even in relatively good economic times, unless preferential tax treatment is available. Because the exception applies only to investors who are willing to put themselves at substantial financial risk, some argue that it does not seriously undermine the general prohibition on passive losses. This argument, however, could apply equally to other industries that are risky and that are facing adverse market conditions. Further, as discussed above, giving preferences to oil and gas extraction may inappropriately subsidize depletion of domestic resources.

REV-10 ELIMINATE PRIVATE-PURPOSE TAX-EXEMPT BONDS

Addition to CBO Baseline	1988	1989	1990	1991	1992	Cumulative Five-Year Addition
	Annual Added Revenues (billions of dollars)					
Eliminate All Private-Purpose Tax-Exempt Bonds	0.3	0.9	1.6	2.1	2.5	7.5
Raise Cap and Extend Volume Limits to New Issues of All Private-Purpose Bonds	0.1	0.2	0.4	0.5	0.9	2.1

State and local governments have for many years issued bonds to finance public investments such as schools, highways, and water and sewer systems. In the past 20 years, these governments also have issued a large and rapidly growing volume of bonds to finance both quasi-public facilities, such as ports and airports, and private-sector projects, such as housing and shopping centers. Because interest on most of these "private-purpose" bonds is exempt from federal taxation, rates on them are below-market. These low interest rates reflect the federal subsidy of borrowing costs for private entities. Under current law, revenue losses from private-purpose bonds will amount to $12.5 billion in fiscal year 1988, rising to $13.9 billion in 1992.

"Private-purpose" tax-exempt bonds include mortgage revenue bonds for rental housing and single-family homes for low- and middle-income households; industrial development bonds (IDBs), used by private firms for a wide variety of purposes; student loan bonds, issued by state authorities to increase funds available for guaranteed student loans; and bonds for nonprofit institutions, such as hospitals and universities. Some bonds subsidize activities that the federal government may want to encourage, such as low-income housing. Even then, however, tax-exempt financing often merely lowers borrowing costs for investments that would have been undertaken anyway. Regardless of the merit of a subsidy or its effectiveness in increasing investment, tax-exempt financing is an inefficient way to provide assistance. With a direct subsidy, the benefits go entirely to the borrower, and the assistance is a line item in the federal budget rather than a less visible off-budget expenditure. With tax-exempt financing, the benefits are shared shared between the borrower of funds and the investor in tax-exempt bonds.

The Congress has put restrictions on the use of tax-exempt financing several times, beginning in 1968. During the 1980s, these restrictions have, among other measures, included limiting the volume of new issues of tax-exempt bonds for some activities and setting sunset dates on the use of tax-exempt financing for other activities.

Most recently, the Tax Reform Act of 1986 placed a single state-by-state limit on the volume of new issues of IDBs, student loan bonds, and housing and redevelopment bonds. The new state volume limits, which are more restrictive than prior law limits, are the greater of $75 per resident or $250 million a year, until December 31, 1987, and $50 per resident or $150 million a year thereafter. Before the Tax Reform Act, the limit for IDBs and student loan bonds alone was $150 per resident or $200 million. Bonds for publicly owned airports, ports, and solid waste disposal facilities, and for nonprofit 501(c)(3) organizations (primarily hospitals and educational institutions) are exempt from the new volume limits. With the exception of hospitals, however, nonprofit institutions may not issue bonds if they have more than $150 million in tax-exempt debt outstanding. This provision primarily will affect large universities. Tax-exemption for mortgage revenue bonds and for small issue IDBs (under $10 million) used for manufacturing facilities will terminate at the end of 1988 and 1989, respectively.

As a result of the Tax Reform Act, the volume of new, private-purpose bonds over the next five years will be about 20 percent less than it would have been under previous law. But while current law limits the growth of new issues, it does not end it--or the continued drain on federal revenues. If the Congress were to eliminate tax exemption for new issues of private-purpose bonds, revenue gains would amount to $0.3 billion in fiscal year 1988, rising to $2.5 billion in 1992. Eliminating the tax exemption could result in higher construction costs for low-income housing and for nonprofit facilities, unless, of course, the Congress provided direct subsidies as a substitute.

Including all bonds for private nonprofit and quasi-public facilities in a single state volume limit and raising the limits beginning in 1988 to $75 million per capita or $200 million a year would raise $2.1 billion over the 1988-1992 period. This would curb the growth of all private-purpose bonds, without sharply reducing their use from current levels. More stringent limits of $50 per capita or $150 million per state for all private-purpose bonds would raise $2.7 billion over the 1988 to 1992 period. Most bonds for nonprofit institutions finance hospital construction and renovation. Advocates of the bonds maintain that they lead to lower hospital and Medicare costs. Those who support limiting or eliminating these bonds question the need for any subsidy when the supply of hospital beds seems to be adequate.

REV-11 TAX CAPITAL GAINS AT DEATH

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1988	1989	1990	1991	1992	
Addition to CBO Baseline	a/	4.9	5.3	5.6	6.0	21.9

a. Less than $50 million.

Realized capital gains are taxed as income. An exception occurs when a person sells an inherited asset, in which case only the gain accrued after the date of inheritance is included in taxable income. (A portion of the inheritance may be taxed under the separate estate and gift transfer tax, but only if the estate is large.) The income-tax exception could be removed either by taxing capital gains on the decedent's final income tax return, or by requiring the beneficiary to carry forward the decedent's cost basis (generally the original purchase price, less any adjustments). Taxation of gains at death would raise about $22 billion from 1988 through 1992.

Taxing gains at death would reduce both the incentive and the opportunity for wealthy families to avoid tax permanently on an important source of their income. It would also reduce the incentive for investors to hold onto assets longer than is economically sensible. This incentive was strengthened by the Tax Reform Act of 1986, which raises the tax rates on capital gains realized before death. This rise, combined with recent reductions in the estate and gift tax, may significantly increase the amount of capital gains held until death to escape taxation.

The major arguments against taxing gains at death are that it would reduce the incentive to save by raising the expected value of future capital gains taxes, and that it might force estates to liquidate assets such as small farms or businesses in order to pay the tax. The forced-sale problem could be reduced by allowing generous averaging provisions and deferral of tax payments.

As an alternative to taxing gains at death, the heir could be made to carry forward the decedent's cost basis (carryover basis). This requirement would avoid the liquidity problem mentioned above because carryover basis allows a continued tax deferral on the unrealized gain for heirs. Enacting carryover-basis provisions would raise $3.5 billion from 1988 to 1992. The Congress enacted carryover basis for assets transferred at death in the Tax Reform Act of 1976, but this provision was postponed for three years in the Revenue Act of 1978, and was repealed in 1980. One of the chief objections to the provision was the difficulty estate administrators and heirs experienced in determining the decedent's basis. This problem resulted in part from the fact that the provision required new documentation not previously needed to comply with tax law. It might be lessened over time, as taxpayers take the provision into account when planning their estates. Neither carryover basis nor the taxation of gains at death is included in the Tax Reform Act of 1986.

REV-12 TAX 30 PERCENT OF CAPITAL GAINS FROM HOME SALES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year
	1988	1989	1990	1991	1992	Addition
Addition to CBO Baseline	0.4	2.0	2.2	2.3	2.5	9.4

The tax on the capital gain from the sale of a principal residence is deferred if the seller purchases another home of at least equal value within two years. If the taxpayer dies before paying tax on the gain, this tax is never owed (see REV-11). (Estate taxes may be due, but only for those with extremely large estates.) Further, taxpayers aged 55 and over may exclude up to $125,000 of gain from a home sale that is not rolled over (the exclusion may only be taken once). Thus, in practice, a large portion of capital gains from home sales is never taxed. If the above provisions were replaced with a tax on 30 percent of capital gains from home sales, $9.4 billion could be raised in the 1988-1992 period.

The current provisions are defended on the grounds that they may prevent hardships for homeowners forced to sell because of a change in family size or unexpected employment change. Some claim they are needed to protect taxpayers from a large tax liability on a lifetime capital gain, and to avoid taxing the portion of that gain that might be attributable to inflation. This latter problem, which is no greater for housing than for other assets, could be avoided with an explicit adjustment for inflation.

The tax code strongly favors owner-occupied homes over other investments (for further discussion of this point, see REV-16). Because capital gains from homeownership are taxed more lightly than gains from stock and other business investment, savings are diverted from more productive investments into housing. The Tax Reform Act increases the value of the tax deferral for home sellers under age 55 because it significantly increases the tax rate on capital gains, thus increasing the incentive for them to reinvest in housing rather than other assets.

To make the treatment of housing more like that of other assets, the deferral and exclusion provisions could be replaced with a small tax on gains from home sales. Under this proposal, the gain on one home would not affect the calculation of gain on successive homes--each purchase of a home would be a separate transaction for tax purposes. This change would simplify both tax administration and taxpayer compliance, especially for those who change homes often, because it would eliminate the need for homeowners to keep track of gains and expenses from a succession of homes. If 30 percent of the gain were included in taxable income, the tax on home gains would be less than 10 percent for taxpayers with the highest marginal tax rate, and would be only 5 percent for those in the 15 percent bracket.

A tax on home gains would lessen but not eliminate the incentive to reinvest gains from home sales in housing. For some taxpayers, it could have the effect of discouraging home sales, just as current law provides an incentive for taxpayers to hold, rather than sell, other capital assets. The economic losses caused by this "lock in" effect might be more serious in the case of home sales than for other assets, especially if families were discouraged from relocating to change jobs. The tax might also deter some homeowners (especially older taxpayers with large accrued gains) from changing homes as family requirements change.

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REV-13 DECREASE LIMITS ON CONTRIBUTIONS TO QUALIFIED PENSION AND PROFIT-SHARING PLANS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Decrease Limits to $45,000 and $15,000	0.9	2.5	2.8	3.2	3.6	12.9
Decrease Limits to $67,500 and $22,500	0.2	0.6	0.6	0.7	0.8	2.9
Repeal Salary Reduction Plans	2.8	5.7	6.2	7.1	8.1	29.8
Decrease the Limit for Deferrals in Salary Reduction Plans to $5,000	0.1	0.3	0.3	0.4	0.4	1.4

Participating in qualified plans is an advantageous way for most taxpayers to save for retirement. The advantages are twofold. First, the investment income earned within qualified plans is not taxed. Second, most deposits to qualified plans are not taxed until they are distributed in retirement, when many taxpayers face relatively low tax rates.

Decrease Limits on Employer Contributions. Retirement payments from defined contribution plans depend on annual contributions, usually expressed as a percentage of each year's earnings, while defined benefit plans specify the pension to be received, usually expressed as a percentage of preretirement earnings. Currently, contributions to defined contribution plans are limited to the lesser of 25 percent of compensation or $30,000 per employee, and contributions to defined benefit plans are limited to amounts that will result in annual benefits of the lesser of 100 percent of wages or $90,000 per employee for any pension that begins at age 65. (For pensions that begin at an earlier age, this limit is reduced on an actuarial basis.) When an employee is eligible for payments from both types of plans sponsored by the same employer, a combined limit applies--the lesser of 140 percent of wages or $112,500 in annual payments.

These funding limits are far higher than the preretirement earnings of most workers. Only one-half of one percent of employees earn more than $112,500 a year. Many analysts have questioned the need to subsidize the accumulation of retirement income to replace earnings up to such high levels, particularly because many workers (especially in the lower half of the income distribution) are not covered by qualified plans and thus do not have access to these subsidies for retirement saving.

If the dollar funding limits for defined benefit plans were lowered to the Social Security wage base ($43,800 in 1987 and $45,000 in 1988), with equivalent reductions in limits for defined contribution plans, the limits would still be higher than the earnings of all but about 7 percent of earners. (The 7 percent of top earners would continue to be subsidized for retirement savings in qualified plans up to the wage base.) Lowering the limit to $45,000 for defined benefit plans and $15,000 for defined contribution plans in 1988 would raise $12.9 billion in 1988-1992. Alternatively, the limits could be lowered to amounts somewhere between current law and those compatible with the Social Security wage base. Limits of $67,500 and $22,500 in 1988 would raise $2.9 billion over five years, and would exceed the earnings of all but about 2 percent of earners.

An argument against reducing dollar funding limits is that individuals with higher incomes would have much less of their earnings replaced in retirement by payments from qualified plans. Such people, who either own most businesses or constitute top management, might decide not to sponsor qualified plans. If that were to happen, then even more workers than now would be excluded from the tax advantages of qualified plans.

Change Salary Reduction Arrangements. Most salary reduction arrangements are part of employer-sponsored profit-sharing plans that allow employees to choose to receive lower current (taxable) compensation and to defer the remainder of compensation as a contribution to the plan. These arrangements typically are called 401(k) plans after the provision of the tax code that authorizes them. Similar arrangements are possible for workers in the nonprofit sector (so-called 403(b) tax-sheltered annuities), for federal workers, and for workers enrolled in some Simplified Employer Plans (SEPs).

The Tax Reform Act of 1986 lowered the cap on the employee deferrals for 1987 in salary reduction arrangements to no more than $7,000 in the case of 401(k) plans, SEPs, and the federal plan, and to no more than $9,500 for 403(b) tax-sheltered annuities. The $7,000 limit will be indexed for inflation starting in 1988. The act also made it easier to maintain 401(k) plans, and it authorized salary reduction arrangements as part of SEPs.

Many people question whether the tax advantages associated with salary reduction arrangements are equitably distributed, because elective deferrals are used mostly by high-income employees with discretionary income. Others argue that the incentive of before-tax savings for employees is unnecessary because those who choose to make elective deferrals would probably save for their retirement anyway. Two proposals to reduce the tax preferences were discussed in the tax reform debate of 1984-1986. One proposal was to repeal 401(k) arrangements. If this proposal was broadened to include all types of salary reduction plans, $29.8 billion would be raised from 1988 through 1992. Another proposal was to limit elective deferrals to $5,000 a year. In comparison to the recently enacted $7,000 and $9,500 limits, a $5,000 limit would raise $1.4 billion through 1992.

On the other hand, salary reduction arrangements are attractive to employers because they are relatively easy to administer. This may encourage employers to extend the advantages of qualified plans to the half of the labor force not now covered. Before further changes are made in salary reduction plans, it may be advisable to see whether these plans are becoming available to workers who otherwise would not be covered by qualified plans.